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¶1. (SBU) Summary. During a series of June 5-6 meetings with U.S. firms involved in upstream petroleum sector operations, our interlocutors complained of Brazil's inadequate climae for foreign investment. In separate meetings,Exxon-Mobil, Chevron, and El Paso recounted talesof Brazil's dysfunctional regulatory regime, high taxes, legal uncertainty, and tenuous security situation. In addition, the difficulties of dealing with GOB agencies such as IBAMA (responsible for environmental permits) and Receita Federal (in charge of customs) complicated the picture. Petrobras' dominance in all aspects of the ol sector, both upstream and downstream, meant that independent players, even well-funded ones, needed to tread lightly. While doing business in Brazil was certainly easier than operating in Bolivia, we were told, in many ways the majors found investment conditions worse than those in Venezuela. End Summary.

ANP VS. PETROBRAS

¶2. (SBU) Overall, Brazil's petroleum sector regulatory apparatus receivd mixed reviews. El Paso's Brazil President, Eduardo Karrer, characterized ANP, the national petroleum regulatory agency, as well-intentioned but often lacking the necessary authority to set things right. When the Director of ANP is close to the President, he said, the agency acts in a confident and decisive manner. In contrast, when the ANP Director lacks political muscle, Petrobras, Brazil's oil and gas parastatal, tends to dictate the rules. Chevron's Tim Miller noted that even though his company often partners with Petrobras on the E&P side, it sometimes receives the thumb-screw treatment from the company's gas division. Miller stated that in one off-shore field where Chevron had found gas reserves, Petrobras - which owned the only pipeline to the shore -

had offered the company a mere 70 cents per million BTU for the gas, knowing full well that Chevron's only alternative was the risky gambit of re-injecting the gas into an underground reservoir.

¶3. (SBU) Exxon-Mobil's Brazil President, John Knapp, was more charitable toward ANP; he noted that the agency had conducted seven transparent auctions of oil/gas blocks during the past few years and described it as "competent and flexible." (See reftel.) The upcoming eigth round of auctions could be the most important yet, he declared. Knapp acknowledged that Petrobras was like an 800-pound gorilla, but pointed out that in many ways it treated independent players more fairly than Statoil - Norway's respected petroleum parastatal - which had been known to eject private sector operators from exploration blocks. Petrobras had never gone to such lengths, Knapp said, though its state-run status gave it access to key information about specific blocks which ensured that it always was able to purchase the most promising parcels.

LEGAL UNCERTAINTIES

¶4. (SBU) Knapp noted that the rules governing the auction of oil/gas blocks were subject to endless changes. For instance, the sixth auction round, he said, could have been even more successful in attracting investors if ANP had not made local content such a key component of bid evaluation. Seeking to correct this mistake, in the seventh round ANP then changed the rules to make local content merely a tiebreaker if there happened to be identical bids - but then required that firms use a minimum percentage of local rigs (of which there are virtually none) when conducting E&P operations. Even more frustrating, Knapp continued, is the lack of clarity in the regulation of natural gas. Currently, there are three bills in

Congress purporting to establish a new regulatory regime for natural gas, but none is adequate from the company's point of view as each would allow Petrobras to keep its monopoly on pipeline operations for a number of years.

¶5. (SBU) Chevron's Miller complained of the ongoing legal uncertainty raised by Rio State's efforts to collect valued added taxes on imported E&P rigs and well-head production. The state statutes establishing these taxes (Lei Valentin and Lei Noel, respectively) on their face appear to conflict with Brazilian constitutional provisions making off-shore petroleum resources subject to the sole jurisdiction of the federal government, he said. However, litigation is still working its way though the Rio State court system and the judiciary had issued conflicting decisions. Meanwhile, Rio State government officials were trying to shore up the legislative basis for these taxes just in case the courts ruled against them. Payment of these taxes, Miller declared, negatively affected the bottom line of all companies in the sector.

¶6. (SBU) Karrer was more upbeat, possibly because El Paso had just settled two multi-million dollar investment disputes with joint venture partners (one with Petrobras and the other with the State of Parana) involving gas-fired thermoelectric plants. Having confronted the lack of transparency on the electricity generation side, El Paso was divesting itself of its gas-fired power plants and planning to concentrate on relatively more "secure" E&P activities.

IBAMA NIGHTMARE

¶7. (SBU) IBAMA, the Brazilian agency responsible for issue environmental permits, came in for the harshest criticism from our interlocutors. Miller stated that a Shell-operated project (40% Shell, 40% Petrobras, and 20% Chevron) was currently on hold awaiting the issuance of an IBAMA permit. Shell had obtained an injunction compelling the agency to issue the required permit, he said, but because IBAMA workers were on strike there was no one available upon which to serve the injunction papers. Meanwhile, Shell was losing US$250,000 per day as its drilling rig sat idle. In a separate field where Chevron was the operator, in partnership with Petrobras, because of IBAMA delays Chevron just received its

permit this year - though the company had scheduled exploration activity to begin in 2005. Although Shell/Chevron had prevailed upon its joint venture partner Petrobras to help grease the skids for both these projects, even the vaunted Petrobras could not get IBAMA to move in a timely manner.

¶8. (SBU) The IBAMA bottleneck not only adversely affects the majors, but smaller players as well. The U.S. firm EMGS had hoped to bring its environmentally friendly electromagnetic survey technology to Brazil (less ecological disruption compared to traditional seismic surveys) but after several months of frustrating, fruitless, and expensive waiting it left for more profitable shores.

¶9. (SBU) Chevron, Exxon, and El Paso all understood the challenges facing IBAMA, noting that inadequate staffing, low salaries, and unclear framework statutes combined to make the agency's job difficult. The constant turnover in agency personnel meant that industry had to educate staffers every three years or so regarding their needs and concerns. Brazilian law was such that should an IBAMA employee mistakenly issue a permit, our interlocutors observed, that person could be held legally liable if something went wrong. Under such circumstances, Knapp pointed out, it was natural for staffers to push issues up to higher levels within the agency rather than making decisions themselves.

CUSTOMS AND LACK OF SECURITY

¶10. (SBU) All three firms complained about the difficulty of clearing key equipment - like drilling rigs - through customs. Frequent strikes and unending paperwork made import/export procedures a challenge. The added liability of doing business in Rio de Janeiro, the country's de facto petroleum capital, only increased their headaches. The recurrent violence and constant threat of kidnap made it hard to attract expatriates to work there. Putting the best face he could on the situation, one company manager pointed out that at least the situation was better than that in Bolivia - though, despite all of President Chavez's antics, it was worse than that in Venezuela.

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